RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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LETTER 1330

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January 4, DJIA 10259.74; PTI 5363; AD Ratio -.13
January 11, DJIA 9987.53; PTI 5344; AD Ratio -.42
January 18, DJIA 9771.87; PTI 5337; AD Ratio -.62
Dow Yield: 1.86% Dow p/e: 26.8
Gold 50 day MA: $ 278.00

THE 50% BATTLE: This is a weekly chart of the Dow. The horizontal line shows the level of the 50% Principle. The 50% Principle applies to the halfway or 50% level of the entire bear market decline (so far), the decline from 11722 to 8235.

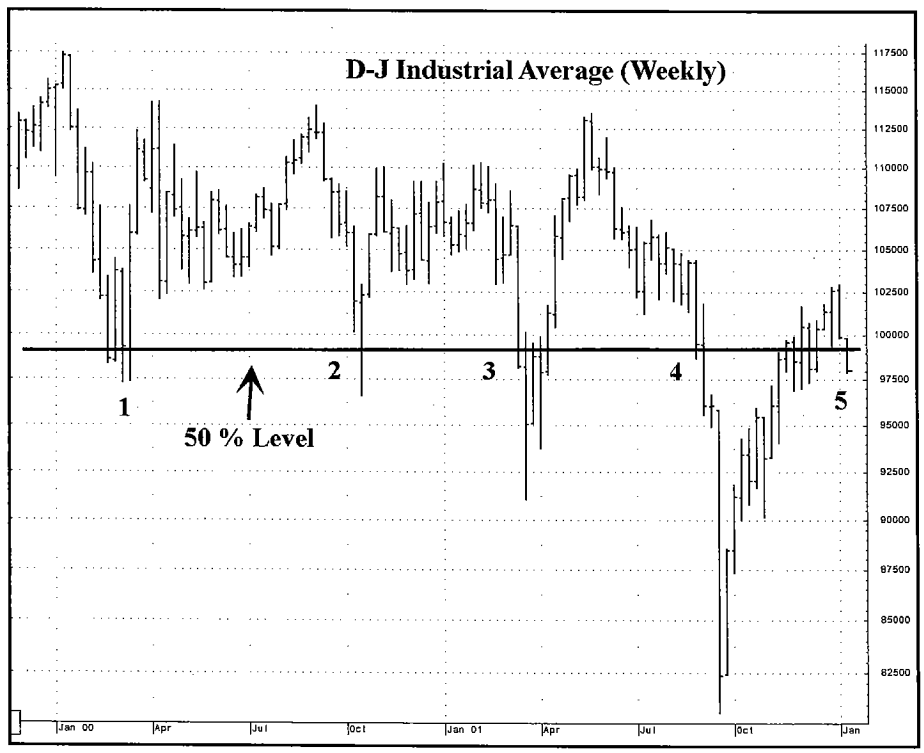
The halfway or 50% level comes in at 9978. Note on the chart that during 2001 the Dow broke below the 9978 level on four separate occasions. Each time there was a recovery. Now in January 2002, the Dow has again broken down below the 9978 level.

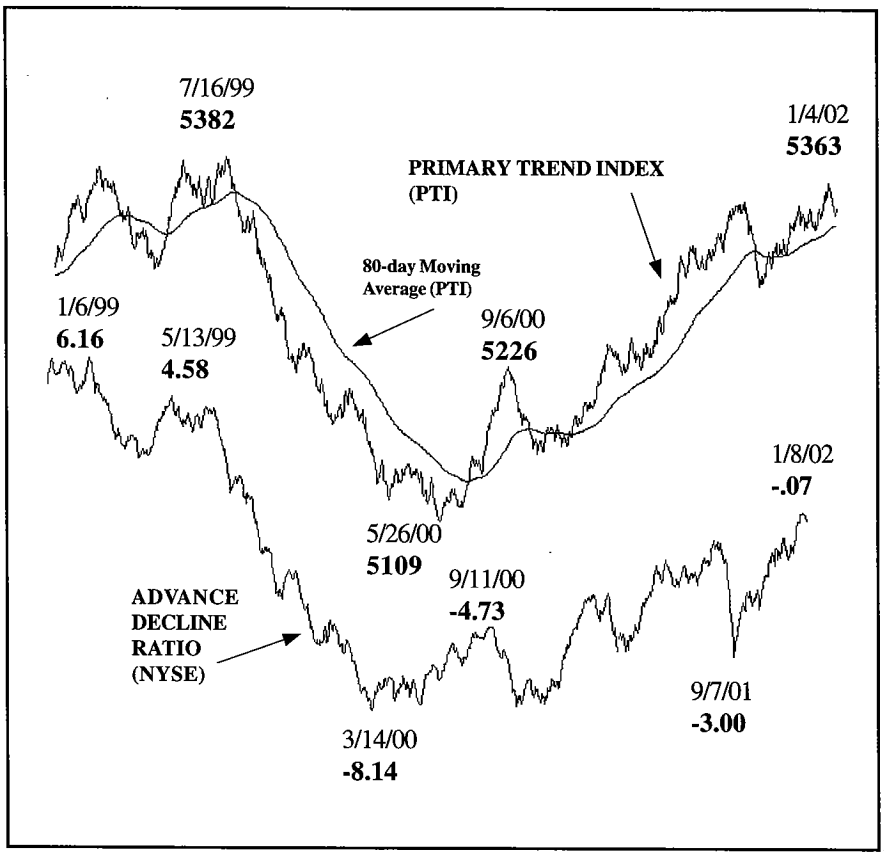
The big question is – will the Dow stay stubbornly below the 9978 level? As long as the Dow is below the 9978 level, the 50% Principle states that in due time the Dow will decline to test or even to break below the low of Dow 8235.

So far, the 9978 or 50% level has acted like a magnet, with the Dow coming down and repeatedly violating that level. Will this time be different? Let's wait and see.

THE PICTURE: The stock markets of the US and the world are currently caught in what I believe will be an historic bear market. We are still, in my opinion, near the beginning of this primary bear market.

I've said all along that when the bear market starts or when the Fed at least suspects that it is starting, the Fed will fight the primary declining trend "tooth and nail." This is exactly what is happening. The Fed has dropped interest rates eleven times in succession while flooding the banking system with liquidity. The Fed, in fact, has added a trillion dollars to the banking system in terms of Fed credit over the last 12 months.





But the primary trend is more powerful than anything the Fed can muster. Despite the massive manipulations of the Fed, the economy continues to be in trouble, and stocks have failed to recoup their huge losses.

Let me introduce a few thoughts. Let's assume that the Fed and the other G-7 central banks have decided that the place to attack the worldwide recession is in the equity markets and specifically the US stock market. This is the most visible market, and it is the place where US citizens have invested a very large portion of their assets (52 percent of Americans now own stocks or mutual funds).

So, think the central banks, let's attack the equity markets with money and credit, as much of it as we can muster. This means flooding the banking system with money, cheap money. Let's float the stock markets higher, let's re-inflate the bubble.

But there's a problem. The problem is inflation. Too much money chasing too few goods means rising prices, and rising prices means declining bonds and declining bonds means rising rates.

It's all right for stocks to go up, think the central bankers, because everybody loves rising stocks, and everybody feels better when stocks (particularly their own stocks) head north. The problem is to divorce rising stocks from the gauges of inflation.

The most widely recognized gauge of inflation is gold. The idea is to divorce paper currencies from anything of intrinsic value with the possible exception of housing. Two-thirds of US families own their own homes, so if equity prices rise and home prices rise, well that's a good thing. That's OK. That's something that will make US consumers happy, and happy consumers are spenders. Therefore, the idea is to divorce all paper currencies from gold and allow the surging liquidity to sift into stocks and housing.

As far as paper money is concerned, the central banks want the ability to print or produce as much paper as they want with no restrictions at all, as long as their printing doesn't show in obvious inflationary statistics or barometers.

Aside from boosting the price of equities and housing, there's a second item on the central banks' wish list. And that is to get consumers to spend. This means encouraging consumers to go further into debt. Right now debt as a percentage of disposable income is at record levels. Debt is now over 100 percent of disposable income (in 1982 it was only 60 percent of disposable income).

How can consumers handle more debt? Two ways – bring down the carrying cost of debt, which means bringing down interest rates. And allow inflation to slowly (and hopefully subtly) lower the total value of debt. But above all, don't let inflation show in the statistics.

Under these conditions, gold becomes the great enemy of the central bankers. The gold standard means that individuals can have real money that is not under the control of governments. The gold standard means that the government can't manufacture "legal tender" money at will. The only way to increase the money supply, under the gold standard, is either to raise the price of gold or to mine more gold. Gold is something intrinsic – it can't be manufactured by government employees who are working around the clock tending printing presses.

You and I work for our money. We sweat, we stay awake nights, we save, we ponder ways of making more money, we worry about paying our taxes and supporting our families. Not so the government. The government can create billions of dollars overnight without anyone working or sweating or doing anything more than making the necessary phone calls.

If I have to work for my money and the government can create money (actually legal tender) without someone working, that's an immoral situation. In a weird way, it makes all of us "slaves" of the government.

And that's one of the cruxes of the current situation. We're all working to make money, money that has no intrinsic value, money that the government produces at will, money that the government creates "out of thin air." Immorality is just another word for evil. And in the end, the only power evil has is the power to destroy itself.

This may sound far-fetched, but I believe the paper-money system will ultimately collapse, and with it will go the whole federal reserve concept. The Founding Fathers detested the idea of paper money, they warned against it, and they outlawed it in the US Constitution. They certainly never allowed an outside entity (the Fed) to take over the money creating powers of Congress. Congress stupidly gave away their power to control money in 1913 when they passed the Federal Reserve Act. How this Act was passed through Congress is another story and a scandalous story at that.

Right now we see the Greenspan Fed pitted against the power of the primary trend of the market. This is the first time in his career that Greenspan has had to operate within the confines of a primary bear market. In a bull market, Fed-generated inflation works well. Fed-created inflation can act like a blast of dynamite under the stock market when the primary trend is bullish.

But in a bear market it's different. In a bear market the Fed can pull every lever, press the pedal to the metal, talk up the economy, lower rates, and the result will not be that they are unable to reverse the tide. The result, at best, will be to partly re-inflate the balloon, but at the same time Fed manipulation will place the economy in an even more precarious position.

Every market advance whether primary, secondary or minor, will ultimately be corrected. The bigger the speculative edifice, the bigger and more severe the correction. This is a law of nature, and it can be drawn out, it can be extended, but it can't be eliminated. The Federal Reserve seeks to change this natural law. They might just as well issue the following edict — "From now on there will be no night. The Federal Reserve announces that from this time on, there will only be day."

The Fed might even have people believing this nonsense for a few hours or so. But after 6PM when night falls, people will realize that the Fed's power to eliminate night is wishful nonsense. The Fed has no such power. By the same token, neither does the Fed have the power to reverse the primary trend.

GROW, GROW, GROW — I've been thinking a lot about the current (and recent) frenzy to grow, to beat last year, to beat the last quarter, to beat the last month. Everybody wants to get in on the frenzy. Make a fortune quickly. Make a killing in the casinos. Grow your earnings, grow your fortune, grow, grow, grow.

What the hell is going on? I think it has to do with greed and maybe with envy. Who are the heroes today, who are our role models? It's the CEOs, the big money guys, Bill Gates, Warren Buffett, Jack Welch, the Hollywood $20 million a movie stars and the big-money sports heroes.

The nation seems to be on a mad role to "make it big time." It's as if there's no rest in the nation.

The stock market, I believe, reflects this modern madness. Dividends have all but been eliminated. So what do you have when you have a basket of stocks that pay no dividends. You have stocks that MUST "grow" their earnings. If they don't grow their earnings, they revert to "dead wood." You're stuck with stocks that are going nowhere and bringing you nothing.

This dividend-less stock syndrome is going to be an increasing problem as the bear market moves on. As stocks decline, and as stockholders become increasingly frustrated, I believe you're going to see a general exit from Wall Street. The public, the stockholding public, is going to become disillusioned with stocks – as they always are during extended bear markets.

But right now I believe that the US public is acting as if the bull market is still with us. I believe we still have the "bubble" with us. After a while, you can get used to almost anything – anything if it lasts long enough feels as though "this is the norm."

I think Wall Street and the stockholding public believe that price/earnings in the high 20s or even the 30s are normal. I think they accept stocks that pay no dividends as normal.

But 150 years of stock history tells us that stocks with P/Es in the high 20s and stocks with no dividends are NOT normal. These are bubble stocks, and in my opinion the bubble is still with us. True, the bubble has been deflated somewhat, but basically the bubble is still here. You can see it in the abnormal valuations.

My overall view is that the market is still in its second psychological phase, and the second phase is the longest phase in the bear market. I believe that in this second phase we will experience the slow but relentless decline of bullishness. As this bear market drags on, people will realize that they are no longer making money in the market. Bullishness will turn to disappointment. Disappointment will give way to frustration and anguish. Finally, frustration and anguish will give way to resentment and anger.

At the final bear market lows as stocks cave in and as great values finally appear, the public will have exited the market and the general sentiment will be – "I never want to hear about the stock market again."

There's only one cycle in the stock market that you can count on, one cycle that has existed since stocks were first traded. And that's the cycle of optimism to pessimism and then the cycle back to optimism again. We call those bull markets and bear markets.

They're always disbelieved at the extremes. It's human nature to disbelieve in change. Yet change is the one thing that you can count on in the markets. As certain as that night gives way to day, bull markets give way to bear markets and bear markets give way to bull markets.

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I received this e-mail a week ago, and I thought it was so interesting and so important that I wanted all my subscribers to read it. I call it — **ENTER THE DRAGON.**

I've been in manufacturing for 46 years and have used your Dow Theory Letters to make business decisions. I remember the 72 to 74 fiasco and remember your Dec. '74 letter announcing the bear market being over. At the time things were really bleak and black.

I thought you might be interested in what I face in manufacturing, and probably many American manufacturers

face. America is in a manufacturing crisis, caused by my government's policy called free trade. It may be free, but it's not fair.
Jack Welch, ex G.E. champion, says globalization is good, perhaps it is for G.E. factories in China, it's not good for Americans looking for jobs in America.

I have a Chinese manufacturer that has invited me to come to China and see his 7 manufacturing plants, and he has encouraged me to set up my own. Four years ago he did $600,000.00 worth of business, now he does $42,000,000.00 He says he's made his investors rich. He has a home in California, Florida, and a vacation home in the islands.

He pays .29/hour. — My starting labor is a minimum of $8.00/hour + incentives.
Chinese tool and die is 1.00/hour. — My tool and die is $20.00/hour.
He has no fringes. — My fringes are about 25%.
He laughs, his help has no rights. — My help has rights.
He has no environmental costs. — I am installing an $85,000.00 waste water system.
He has no OSHA. — It costs me $300,000.00 to set up an OSHA approved line.
He has no OSHA consultant. — Mine costs about $7,000.00 a year.
He has no environmental consultant. — My consultant and tests cost $20 to 30,000.00/year
He has taxes. — My taxes are 16 times greater.
He brings 9 products to market for $7,500.00 (tooling/equipment cost). My one product costs me a minimum of $500,000.00 (tooling/equipment cost).
He boasts of all the accounts he has. — Many of them were mine.

A manufacturing friend in Indianapolis told me recently, he's moving his American manufacturing facilities to China, he has no choice, he can no longer compete.

A local banker says we are locally losing several small companies every week.

It seems manufacturers in America are sliding into depression. I normally have 40 or more people daily looking for work (some days as many as 200). America is losing our manufacturing base.

We have steel warehouses and packaging suppliers, pleading for orders. The tooling industry (tool & die) has been virtually destroyed. Many have gone out of business, and the remaining have cut their work forces drastically, many to half force. They call and plead for work. Their counterparts in China are paid 5% of their pay.

Additionally we have a horde of expensive, difficult government regulations and laws that we must adhere to. It appears my government is attempting to destroy American industry.

Of course this will negatively impact the government tax revenues as people stop working and paying taxes and start drawing unemployment or financial aid from the government.

The Dow is still near it's high. Many other stocks have crashed. Could it be that the large manufacturers (Dow 30 types) have moved their manufacturing to China, closed or reduced American facilities, which has kept profits up relative to the American economy and the manufacturing that has not gone offshore? Consequently the Dow 30 is the last to fall, but as layoffs increase, consumer spending will slump, and in the end if the Dow 30 companies have severely reduced sales, it won't matter what their costs are, their stock will drop.

INVESTMENT POSITION: When I first started out investing in the late 1940s stock buyers weren't obsessed with rising prices the way they are today. In the 1940s and even the '50s investors were interested in stability and income. If a stock was paying a safe, well-covered generous dividend that was fine. Just let the dividends keep rolling in, and if the price of the stock headed higher, great, that was an added bonus.

Today the great majority of stocks pay little or nothing in the way of dividends. That puts huge emphasis on stocks rising. If you buy a stock and it pays nothing, what do you have to look for but a rising price? And if the stock doesn't advance in price, it's a dog, it's "dead wood."

This is one of the main reasons why all this phony, crooked, accounting goes on. It's "do anything" to make the stock look better, anything to make the stock push higher. Every CEO today is pressured to drive the price of his stock higher. If the stock doesn't perform, the CEO can look for another job; he's on his way out.

There are three forces that go to make real money in both stocks and bonds. The first force is values – you've got to buy values. Buying values is the essence of the Dow Theory.

The second force is the force of the great primary trend. Stay invested in harmony with the primary trend and you're almost sure to make money. Invest against the primary trend and you're looking for patched pants and shoes with holes in them.

The third force is compounding. Stay on the compounding path and you're almost sure to build your fortune. There's no force like the force of compounding. In compounding, you're building with mathematic certainty.

Harnessing these three forces is, to my mind, the best way for the average investor to operate. Buy values when the primary trend is up and compound those values. I know of no better way to get on, and stay on, the path to wealth.

But what do we do when the primary trend is down? Buy top-quality bonds, and compound them, along with a sprinkling of defensive, dividend-paying stocks including preferreds.

LATE NOTES – The Enron bankruptcy is the largest in US history, and it's repercussions will go on for years.How much will the Enron mess affect the stock market and the way corporate earnings are reported? I really don't know, but I would have to guess that there will be huge repercussions. With "operating" earnings, "pro forma" earnings, current earnings, trailing earnings, — nobody today knows what the devil the corporations are talking about. The fact is that corporations can announce literally any earnings they want, thus the famous "one cent better than expectations" has become an almost mindless addition to Wall Street-speak.

One thing is sure – if a corporation produces a series of increased dividends, that corporation must have real earnings. You can't pay a dividend unless you're making money (of course, you can borrow to pay a dividend, but that's a ticket to bankruptcy, and it can easily be seen in a corporate statement. Also, you can't make a practice of doing it). What we're seeing now is a drop-off in revenue among some of America's biggest and most important corporations. A squeeze in pricing power and a decline in sales is a sure path to trouble. For instance, IBM in its latest report showed that the company's revenue in 2001 was 3% below that of the year before. Furthermore, hardware revenue sunk by 12%. Just not good.

Microsoft's chief financial officer, John Conners, reported that "We are concerned about the health of the global economy and have yet to see a recovery in many of the world's largest economies."

Turning to the market, I've placed major emphasis on the action of the Dow.

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